NOTES

WASHINGTON NOTES

FEDERAL RESERVE REPORT

War's effect upon national finance and banking is reflected in the *Fourth Annual Report of the Federal Reserve Board*, transmitted to the Speaker of the House of Representatives on Tuesday, January 22. The Board reviews the conditions brought about by the great growth of foreign trade and the various measures, intended to remedy resulting difficulties or forestall dangers, that have been put into effect in consequence. Chief among the latter are the provision of a large supply of Federal Reserve notes, which were prepared and conveniently stored early in the year 1917, the development of numerous expedients for the conservation of the gold supply, and the application of the amendments of June 21, 1917, to the Federal Reserve act, for the purpose of enlarging reserves and strengthening the lending power of the several banks.

The Board calls attention to the effect of the war upon the banking and credit situation, both public and private, pointing out the rise in prices, but emphasizing the fact that while during the year 1917 there has been a lessening of the fluidity and availability of the country's banking resources, the change is not surprising in view of the heavy requirements. It also points out that these changes in prices are not necessarily due to alterations in the banking position, but that abnormal demands and the withdrawal of labor and capital have had an important and far-reaching effect. "Banking expansion," the Board says, "is an unavoidable incident of war finance, but every effort should nevertheless be made to counteract it so far as possible by eliminating banking credit not clearly needed for the purpose of purchasing or carrying goods necessary for the life of a nation at war."

From the standpoint of the private individual it is noted that the effect of the government's buying on a large scale has been to withdraw from the market a large proportion of the funds normally available for other loans. This tendency has resulted in an effort to make paper ordinarily regarded as ineligible available for rediscount at Federal Reserve banks. The policy of the Board, however, has invariably been to refuse such applications and to maintain the liquid character of

bank assets. "Under no circumstances," says the *Report*, "can the Board admit the eligibility of paper . . . . which in its essential character fails to conform to sound banking principles."

The *Report*, however, suggests early consideration by Congress of the problem of corporate financing, in the belief that no satisfactory solution of the general corporate and credit problem will be found that does not involve some degree of government intervention. The Board is of the opinion that some plan for such intervention or aid can be worked out that will meet the situation satisfactorily.

One effect of the war has been to enlarge the earning power of the Reserve banks in a very material degree. The gross earnings are given as $15,800,000, and the net earnings as $11,200,000. The dividends declared during the year are about $6,800,000. Six of the banks have paid their dividends completely up to the end of the year 1917, while four others have paid up to June 30, 1917, and the remaining two have paid to the end of the year 1916. Although the banks are not operated primarily for profit, the Board calls attention to the fact that during the coming year their earnings will undoubtedly be large, and that a substantial franchise tax will be paid to the government out of excess earnings. The amount paid this year to the government is $1,134,234.

In connection with the management of the banks the Board explains that the events of the past year have done much to bring into their proper relationship the several elements of the Federal Reserve System, and that the position of the Board as the governing body of all the banks is now well defined, the line of distinction between the local management of each institution and the general policies of the Board growing more and more marked. Among the activities of the year that are incidentally described are the further extension and development of the clearing and collection system and the continuation of work under the Clayton act, permits for service as directors being granted in 182 cases. Applications for fiduciary powers have been granted in 112 cases.

The expense of conducting the work of the Board during the year has been a little less than $250,000, including all salaries, while the cost of the Gold Settlement Fund for the year has been about $3,500, or $0.013 per $1,000.

While no far-reaching amendments to the Federal Reserve act are recommended, a number of minor changes are suggested for the consideration of Congress. Among these are: a change in the present method of electing directors called for by the fact that under present conditions only a minority of all banks entitled to vote are taking an active part

in the selection; a change in the denominations of Federal Reserve notes intended to permit the issue of large bills; a change in the terms of section 22, which relates to transactions between directors and their respective banks; and the amendment of section 25 designed to provide for the incorporation under Federal Reserve charter of banks for foreign trade.

In closing, the Board calls attention to the fact that owing to the concentration of reserves the Federal Reserve System is today the ultimate resource of the business and financial community and that its position as such is unquestionable. The responsibility thus laid upon it emphasizes the necessity of making sure that every policy adopted must be developed with the view of maintaining and strengthening the financial position of the country, and of providing for the readjustments to follow the war.

THE FARM-LOAN SITUATION

An interesting phase of the investment situation produced by the large government loans of the past year is illustrated by the threatened collapse of the federal farm-loan system unless supplied with government funds. In order to insure the sale of the bonds that may be offered by the Federal Farm Loan Board, in behalf of the various farm-loan banks, an administration plan has now been adopted by Congress under the terms of which the Treasury may, for two years, annually purchase farm-loan bonds to an amount of $100,000,000. This measure is offered because of the difficulty or impossibility of selling farm-loan bonds upon any other basis owing to the lack of private purchasing power. It will help to carry the federal farm-loan banks through the period of difficulty, but will of course help the broader situation as to farm investments but little. This situation may be briefly described.

Before the federal farm-loan system was established (and with the aid of that system since its establishment) the farmers of the country were financed by: (1) American mortgage concerns dealing in farm mortgages; (2) American insurance companies; (3) foreign investment or insurance companies; and (4) individual or independent private investors. The supply of capital from abroad, and especially from Great Britain, has now fallen sharply off, and the English government has indicated a desire that the companies reduce their foreign investments of this class. Domestic companies have made reductions of like character on account of the attractive prices at which bonds and stocks are selling, while the individual investor has been putting his new funds into

Liberty Bonds and in some cases calling in his mortgage loans in order to subscribe more heavily. While farmers have in many cases been in good position to meet demands upon them owing to high prices for products, in other cases they have been unfortunate or unable to liquidate the whole of their indebtedness. The farmer suffers from the disadvantage that a large proportion of the mortgages he has given are of short term, running originally not more than three years, so that he is obliged to bear the full force of unfavorable market conditions as his mortgages mature. In some instances, moreover, he has expected to turn to the new farm-loan system in order to renew his accommodation and avoid foreclosure and loss of his land.

The farm-loan system now finds itself hampered by the difficulty of marketing its bonds at ordinary rates of interest or, as an alternative, of competing with the government by raising the rates it is willing to allow on the bonds. This situation is the basis for the proposal practically to have the government supply the means with which to purchase farm-loan bonds—a proposal made when the Farm Loan act was originally under consideration, but at that time rejected. There is as yet no certainty of the course to be followed. Even if the means proposed for guaranteeing the sale of farm-loan bonds should be provided, they would bear only a very small proportion to the volume of farm obligations outstanding. The total amount of farm loans thus outstanding in the United States is estimated at over $4,000,000,000, while the annual loans are stated as $500,000,000. Where farmers are not placing themselves in position to pay their obligations through saving they are thus, in common with other borrowers, facing a situation of difficulty and embarrassment as the result of the war, while the acquirement of new capital is practically out of the question.

FOREIGN EXCHANGE REGULATIONS

The new regulations for the control of foreign exchange, whose administration has been intrusted to the Federal Reserve Board under the supervision of the Secretary of the Treasury (Executive Order of January 26, 1918), provide for a complete system of registering dealers in exchange. The term "foreign exchange" is held to include checks, drafts, bills of exchange, cable transfers, or any form of negotiable or assignable instrument or order used to transfer credit or to order the payment of funds in any foreign country, insular possession, or dependency of the United States. Every dealer in exchange as thus defined is required to file with the Federal Reserve Board an application for a registration

certificate. The application shows the character of business engaged in and whether or not an enemy or ally of an enemy of the United States has any interest directly or indirectly in the business. It also embodies an agreement to comply with the regulations of the Board and to permit inspection of books by agents or representatives of the Board. Dealers in exchange are then classified in three groups: one including those who may or may not carry balances or securities with or for foreign correspondents; a second including those who carry foreign balances but do not maintain accounts for foreign correspondents; and a third, those who carry balances for foreign correspondents but who maintain no foreign accounts. The Federal Reserve Board is to issue licenses to dealers of the various classes, and thereafter each licensed dealer must require customers to file statements showing the purpose of their purchases or sales of exchange. Whenever any holder of a license believes that any transaction within his knowledge involves the payment of funds or delivery of securities to, or the transfer of credit or securities for, the benefit of an enemy or ally of an enemy, he is required to make immediate report of his findings accordingly. The Federal Reserve Board, if it believes that any transaction involves trading with the enemy, may cause notice to be served requiring postponement of the consummation of the transaction for ninety days and may then prohibit the transaction entirely if it desires. Full provision is made for the collection of interest coupons, dividends, and the like, and a general system of control is instituted. When the books designed for the management of the new plan have been duly opened, the data collected from month to month will furnish a clear picture of the foreign trade of the country as reflected in its exchange transactions. If fully carried into operation, the plan should present a balanced statement of the transactions of the country which would be capable of careful checking up with merchandise returns. This is in substance the plan that has been pursued in foreign countries where a similar control of exchange has been practiced. When ultimately made public, these data, while not disclosing anything with reference to individual transactions, should furnish much useful analytical information for the closer study of external trade relationships.

An interesting feature of the regulations is their inclusion of dealings in foreign securities, payment of dividends, collection of maturing obligations, and the like. Trading in such obligations and securities is brought under very close surveillance, and declarations intended to establish that operations of this kind are not for enemy account must be

made. The older regulations respecting the exportation or "earmarking" of gold coin or bullion are reiterated in substance, and made a part of the new set of regulations.

PRIORITIES IN CAPITAL ISSUE

Secretary of the Treasury McAdoo has taken the next logical step in connection with the control of the resources of the country in the interest of the war by establishing an informal system for passing upon capital expenditures. For some time past, as a result of the difficult conditions in the financial markets, private enterprises have found it increasingly difficult to obtain banking accommodation and have been able to do so only at high rates. The situation has indicated that, with the large government loans that were being placed, there was left in the market only an inadequate supply of credit for private needs. One consequence has been to stimulate a belief on the part of many issuers of securities that combined action was necessary in order to bring about joint or co-operative agreement as to which securities should be given preference in the market and should thus be assured of sale while at the same time the necessities of the Treasury were sufficiently taken care of.

The Secretary of the Treasury, in his announcement made public on January 12, calls attention to the fact that any present restriction of capital issues must be voluntary, inasmuch as there is no law which makes provision for a government supervision or control of such sales or offerings. The indications are, however, that in most parts of the country those who have securities to sell will voluntarily co-operate with the effort to regulate the volume to be placed on the market. By so doing, it is evident that those who obtain approval even though in an informal way, will find it easier to dispose of their bonds or shares and will find banking accommodation very much easier to obtain. The task of thus passing upon priorities in capital issues is to be governed by the conclusions reached in each case as to whether a given proportion is or is not intended to produce something necessary for public health and welfare or contribute to the furtherance of the war. This is a question not only of capital but also of material and labor. Public improvements or new private enterprises, which in times of peace might be entirely proper, are thus to be considered on the new basis in the light of, or in connection with, the problems arising out of military necessities.

The United States is following in this matter a course which has already been mapped out by other countries engaged in the present war. It is a course of action which is rendered necessary by the fact that

government loans of the kind which have become familiar in connection with recent financing practically sweep the field clear of all accumulations of investment funds for the time and make it imperative that there should be some restriction of credit accommodation both as to time of offering and as to amount of sale in order to protect both the government and private issuers. In a country of the great extent and wide diversification of resources of the United States this problem of regulation is, however, far more serious and delicate than elsewhere.

THE WAR-FINANCE CORPORATION

Just at the close of January, the Secretary of the Treasury announced a project for the establishment of a so-called "War Finance Corporation" designed to support and confirm banking and industrial credit. On February 9 he appeared before the Senate Finance Committee for the purpose of advocating the adoption of the plan in a definite form. The proposed measure is intended to meet the conditions produced by the decline of securities and the possible effect of withdrawals of funds from savings banks unable to liquidate their long-term investments.

The government's borrowings, particularly during the period immediately preceding and following each Liberty Loan, have tended to pre-empt the credit facilities of the banks, and often to prevent them from giving needed and customary help to quasi-public and private enterprises. In not a few cases some such enterprises engaged in work more or less directly essential to the war have been prevented from obtaining the advances necessary to enable them to perform essential service because bank credits ordinarily available are being absorbed by the government itself.

To accomplish these ends there is planned a corporation with a capital of $500,000,000 subscribed by the government and authorized to issue its own obligations to eight times that amount, or $4,000,000,000. These obligations might be issued to any one or all of three classes of borrowers: (1) to banks which have made advances to, or become purchasers of, the paper or obligations of enterprises deemed essential or contributory to success in war; (2) to savings banks requiring assistance; and (3) in exceptional cases directly to enterprises which are engaged in war work. Notes issued by the concern would be given to such banks or private undertakings against the latter's own obligations secured as circumstances might permit.

These notes of the war-finance corporation would be subject to rediscount at Federal Reserve banks, and the latter would be authorized

to deal in them just as in government bonds. When desired, Federal Reserve notes could be issued against paper secured by these war-finance obligations. It is thus seen that, theoretically at least, an issue of $4,000,000,000 of Federal Reserve notes might be the result of the operations of the corporation. True every such Federal Reserve note issued would still have to have behind it the 40 per cent of gold reserve required by law; but as is well known the percentage of gold reserve behind Federal Reserve notes is already declining as the result of war financing and is now from 60 to 65 per cent. We are receiving no new gold from outside the country, and what there is in circulation domestically is now being collected into the banks but slowly. Any large increase of Federal Reserve notes, therefore, should it occur, would merely mean a reduction in the reserve percentage and might be carried to the point of requiring a suspension of reserve requirements—a power conferred by law upon the Federal Reserve Board.

The question is thus raised whether to continue the plan for the War Finance Corporation upon its present basis, or to alter it by eliminating the power to issue Federal Reserve notes against war-finance paper, or possibly the entire provision for rediscounting at Federal Reserve banks.

Other matters relating to the management of the new corporation, the method of appointing its directors and officers, as well as various points of detail, are still under consideration.

In support of the measure is urged the fact that something similar to it has been resorted to in most of the European belligerent countries, while against it is urged the possible danger to ensue from an enlargement of the currency outstanding or of the general burden upon Federal Reserve banks. The prospects of passing the measure are improved by the fact that various enterprises strongly represented in Congress have found themselves so hard pressed for capital and credit as to render it essential that they find some way of supplying their requirements. The proposed bill holds out some encouragement to them by offering an avenue through which at least a measure of relief may be obtained.